CITY OF HOUSTON — Finance Department

Interoffice Correspondence

To: Budget and Fiscal Affairs Committee

From: Michelle Mitchell, Director
Finance Department

Date: February 29, 2008

Subject: Credit Market Overview

Given the recent events in the credit markets, this memo provides an update and overview of the credit markets and how recent events have impacted portions of the City debt. While the credit markets have experienced turmoil over the past year, this memo will focus on one segment (Auction Rate Securities) that has been especially volatile and how it affects the City. Refer to Exhibit 1 for a summary of the City's various Auction Rate Securities ("ARS"). Even though the City's financial performance (both General Fund and Enterprise Funds) has been improving over the past few years, current market conditions have created a challenge in the ARS segment, which has necessitated consideration of a number of corrective actions to be discussed later in this memo.

Background

In the spring of 2007, the credit markets were roiled with the news of the Sub Prime Mortgage issue (more broadly referred to as Collateralized Debt Obligations or "CDO's"). These events resulted in the re-evaluation of securitized mortgages and CDO's in light of their changing credit worthiness. Higher interest rates and the reset mechanisms contained in many of these Sub Prime loans has led to higher interest rate resets for the mortgage holder and the prospect of higher than anticipated default rates on the underlying mortgages. Weak underwriting standards and credit concerns also became an issue. This caused a downward re-evaluation of the value of these widely held securities. Many leading financial institutions were forced to revalue these securities at a loss and subsequently forced to recapitalize their balance sheets to offset the losses as these securities were marked to market. Investment Banking firms faced capitalization issues as a direct result of the re-pricing of these Sub Prime Mortgages and CDO's. Banks and other financial institutions face similar challenges.

More recently, most monoline insurers (Exhibit 2) have been negatively impacted. The drop in value of Sub Prime Mortgages and CDO's, which are backed in part by some of these monoline insurers, has resulted in downward ratings pressure on these insurers, as the failure of these securities might require the monoline insurers to cover these potential losses and increase reserves now to cover such anticipated claims.

Issuers like the City of Houston have used these monoline insurers to enhance the rating on long-term bonds, in addition to supporting other securities such as ARS. These problems with the monoline insurers translate into uncertainty, a lack of liquidity, and higher costs. This has made it more difficult for issuers, like the City of Houston, to benefit from, and remain with, certain financial products.

City Debt Profile

The City utilizes a variety of debt structures and maturities as noted below:

- Short Term Debt such as TRANS and Commercial Paper Facilities

- Long Term Bonds

    1. Fixed Rate
    2. Variable Rate Demand Bonds (VRDB's)
    3. Auction Rate Securities (ARS)

The vast majority of the City's debt is issued at fixed rates, which means once the rate is set, it does not change, which could be 20 to 30 years. There has been no impact to the City's existing fixed rate debt. While the above segments are performing reasonably well, ARS are not. Given the rate differential illustrated in Exhibit 3, the City is pursuing alternatives to ARS, which are discussed in greater detail below.

ARS Background

The ARS structure was first introduced in 1984 and involves securities whose rate of interest is reset periodically and that have long-term maturities. The interest rate is reset through a Dutch Auction process usually at intervals of 7, 28 or 35 days. They trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long term bonds, they are priced and traded as short term instruments because of the interest rate reset mechanism and the willingness, historically, on the part of the broker dealers to provide clearing bids so as to maintain an orderly market, ensure the success of each auction and provide liquidity to investors who may have wished to sell. The success of the ARS market, which now stands at about $328 billion, can largely be attributed to the fact that investors were attracted by the incremental yields offered by these instruments which had come to be viewed as money market obligations.

Over the last few years the number and profile of investors in ARS have been undergoing some change, shifting to retail and high net worth investors. This development accelerated in light of the market turmoil that began last summer when volatility, illiquidity and "spread-widening" impacted the money markets, contributing to supply-demand imbalances in the ARS market. At that time, the market recorded its first spike in the number of failed auctions (not enough bids to buy the ARS). Whereas only 13 failed auctions, largely linked to credit events, were recorded during the entire period between 1984 and 2006, 31 failed auctions were believed to have occurred during the third and fourth quarters of last year. As investor sentiment turned more cautious, additional auction failures were being reported and a total of 32 failed auctions were reported during the two-week period starting at the end of January. More recently, failed auctions have become widespread and common. The rise in auction failures follows from the banks' decreased willingness to provide market liquidity support, as they have no obligation to do so.

Features: ARS vs. VRDB

Feature	ARS	VRDB
Long Term Maturity	Yes	Yes
Interest Rate Reset	7, 28 or 35 days	7, 28 or 35 days
Short Rate/Long Rate	Short	Short
Puttable by bond investor	No	Yes
Liquidity Provider	No	Yes

The crucial issue that is highlighted above between the ARS and the VRDB's is the ability of the holder of the security to "put" their bonds. A holder of an ARS must hold their bonds until maturity unless a buyer can be found, while a holder of a VRDB has the option to put their bonds on any auction day.

Alternatives

1. Status Quo

   If the City chooses to maintain the status quo the rate on the ARS securities will likely remain high and interest expenses will significantly exceed budgets.

2. Convert or Refund to VRDB

   If the City chooses to either refund or convert to VRDB's, the interest rate paid by the City on this debt should return to normal levels as evidenced by Exhibit 3. In situations where the City has hedged debt (swaps), the preference will be to use VRDB's. The monoline insurer will need to be terminated on the current ARS and replaced by higher rated banks with letters of credit (LOC).

3. Convert or Refund to "Puts"

   In some instances, the better option would be to convert or refund the current ARS securities to "puts." By converting to a put structure, the City could effectively lock in a fixed rate for a predetermined number of years (likely 2 to 5 years). This enables the City to lock in a rate for an intermediate period of time and get out of the current short-term resets. As the put date approaches, the City can review the options at that time, with the expectation that the markets will have stabilized. A benefit of this option is the ability to keep the insurer in place, and provide additional time for the insurer to stabilize as well.

4. Fix Out

The City could also choose to “fix out” the debt. Under this option, the City would refund the current Auction Rate debt to long-term debt with fixed rates. A benefit of this option is the debt will be set at a fixed rate and will remove interest rate uncertainty. The downside is that interest rates may be higher than the VRDB option, but lower than the ARS. Additionally, fixed rates could likely be higher than normal because the cost of insurance by the few remaining, active monoline insurers has increased dramatically and because of the current uncertain market conditions. The debt could also be issued uninsured, if that is more economically beneficial to the City. Finally, a number of other entities (cities, counties, hospital districts, etc.) are in the same situation as the City. Consequently, the long-term market could soon be saturated with a number of new issues, which could push rates higher.

Recommendation

The City must address these issues and uncertainty in the ARS segment. The status quo option is unacceptable in most instances because the prospect of the ARS market correcting itself in the near term is unrealistic. The difficulty with the monoline insurers further compounds the problem. Each situation will be evaluated and recommendations will be made that are unique to the facts and issues pertaining to the specific debt.

Over the next few weeks, a number of RCA’s will be forthcoming specifying a recommended solution for each individual situation.

EXHIBIT 1

City of Houston Short Term Portfolio

INDEX

1 Mo Libor 3.12000% 2/26/08

City of Houston Combined Utility System

CUSIP	Maturity	Series	Type	Lead Underwriter	Issue Size (000s)	Outstanding (000s)	Insurer	Underlying Rating Moody's/S&P/ Fitch	Index	Failed Auction Rate Multiple [4]	Index Rate	Failed Rate [4]	Maximum Rate	Current Rating of Insurer as of 2/25/08
Series 2004B * - Tax-Exempt Auction Rate Securities														A3/A-/A
442435BH5	5/15/2034	B-1	ARS	Bear Stearns	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435BJ1	5/16/2034	B-2	ARS	Bear Stearns	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435BK8	5/17/2034	B-3	ARS	Bear Stearns	$67,775	$67,775	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
					Total	$217,775								
442435CC5	5/18/2034	B-4	ARS	Goldman Sachs	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435CD3	5/19/2034	B-5	ARS	Goldman Sachs	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435CE1	5/20/2034	B-6	ARS	Goldman Sachs	$67,775	$67,775	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
					Total	$217,775								
442435BZ5	5/21/2034	B-7	ARS	UBS	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435CA9	5/22/2034	B-8	ARS	UBS	$75,000	$75,000	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
442435CB7	5/23/2034	B-9	ARS	UBS	$67,775	$67,775	XLCA	A2 / A+ / A	1 Mo Libor	250%	3.12000%	7.8000%	10%	
					Total	$217,775								
					Overall Total	$653,325								
Series 2004C ** - Tax-Exempt Auction Rate Securities														
442435BQ5	5/19/2034	C-1	ARS	JPMorgan	$25,050	$25,050	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	Aaa/AAA/AA
442435BR3	5/20/2034	C-2A	ARS	JPMorgan	$100,000	$100,000	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	
442435BS1	5/21/2034	C-2B	ARS	JPMorgan	$100,000	$100,000	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	
442435BT9	5/22/2034	C-2C	ARS	JPMorgan	$100,000	$100,000	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	
442435BV4	5/23/2034	C-2D	ARS	Lehman	$100,000	$100,000	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	
442435BW2	5/24/2034	C-2E	ARS	Lehman	$98,150	$98,150	AMBAC	A2 / A+ / A	1 Mo Libor	200%	3.12000%	6.2400%	10%	
					JP Total	$325,050								
					Lehman Total	$198,150								
					Overall Total	$523,200								
Series 2004C - Taxable Auction Rate Securities														
442435BX0	5/25/2034	C-3	ARS	Lehman	$23,100	$23,100	AMBAC	A2 / A+ / A	1 Mo Libor	235%	3.12000%	7.3320%	10%	Aaa/AAA/AA
442435BU6	5/26/2034	C-4	ARS	JPMorgan	$48,425	$48,425	AMBAC	A2 / A+ / A	1 Mo Libor	235%	3.12000%	7.3320%	10%	
442435BY8	5/27/2034	C-5	ARS	Lehman	$128,900	$128,900	AMBAC	A2 / A+ / A	1 Mo Libor	235%	3.12000%	7.3320%	10%	
					JP Total	$48,425								
					Lehman Total	$152,000								
					Overall Total	$200,425								

* On June 10, 2004 the 2004B were swapped as follows: Goldman Sachs $353.325 million, Bear Stearns $150 million and UBS AG $150 million.

** On November 1, 2005 the 2004C were swapped in the amount of $249.1 million on a floating to fixed basis with Royal Bank of Canada.

** On August 31, 2006, the 2004C were swapped with a Constant Maturity Swap with Goldman Sachs Capital Markets in the amount of $249.1 million

EXHIBIT 1

City of Houston Convention Center and Entertainment

CUSIP	Maturity	Series	Type	Lead Underwriter	Issue Size (000s)	Outstanding (000s)	Insurer	Underlying Rating Moody's/S&P/ Fitch	Index	Failed Auction Rate Multiple [4]	Index Rate	Failed Rate [4]	Maximum Rate	Current Rating of Insurer as of 2/25/08
Series 2001C - Revenue Adjustable Rate Bonds (Convention Center)														
44237NDA7	6/30/2034	2001C	ARS	UBS	$75,000	$75,000	AMBAC	A3 / A- / NR	Footnote 1	175% [3]	1.95000%	3.4125%	10%	Aaa/AAA/AA
Series 2001C- Revenue Adjustable Rate Bonds (Hotel)														
44237NDB5	6/30/2034	2001C-2	ARS	UBS	$75,000	$75,000	AMBAC	A3 / A- / NR	Footnote 1	175% [3]	1.95000%	3.4125%	10%	Aaa/AAA/AA
					UBS Total	$150,000								

City of Houston Airport

CUSIP	Maturity	Series	Type	Lead Underwriter	Issue Size (000s)	Outstanding (000s)	Insurer	Underlying Rating Moody's/S&P/ Fitch	Index	Failed Auction Rate Multiple [4]	Index Rate	Failed Rate [4]	Maximum Rate	Current Rating of Insurer as of 2/25/08
Series 2000P - Auction Rate														
442348L22	7/1/2030	2000P-1	ARS	Goldman Sachs	$50,000	$47,450	FSA	A1 / A+ / AAA	Footnote 2	125%	3.00000%	3.7500%	15%	Aaa/AAA/AA
442348L48	7/1/2030	2001P-2	ARS	Goldman Sachs	$50,000	$47,225	FSA	A1 / A+ / AAA	Footnote 2	125% +10bp	3.00000%	3.8500%	15%	Aaa/AAA/AA
					Sub-Total	$94,675								
Series 2002 - Auction Rate														
442348V96	7/1/2032	C	ARS	JPMorgan	$100,000	$100,000	XLCA	A1 / A+ / A+	1 Mo Libor	200%	3.12000%	6.2400%	10%	A3/A-/A
					Sub-Total	$100,000								
442348W20	7/1/2032	D-1	ARS	Bear Stearns	$75,000	$75,000	XLCA	A1 / A+ / A+	1 Mo Libor	200%	3.12000%	6.2400%	10%	
442348W38	7/1/2032	D-2	ARS	Bear Stearns	$75,000	$75,000	XLCA	A1 / A+ / A+	1 Mo Libor	200%	3.12000%	6.2400%	10%	
					Sub-Total	$150,000								
442348X29	7/1/2030	A	VRDB	Citigroup	$92,900	$92,900	FSA	A1 / A+ / A+	1 Mo Libor	200%	3.12000%	6.2400%	10%	Aaa/AAA/AA
					Sub-Total	$92,900								
					Total	$437,575								

[1] Kenny or after tax equivalent rate, which is the product of AA Financial CP Rate and (1-Statutory Corporate Tax Rate) 1.95%
[2] 7-day AA Composite CP Rate 3.00%
[3] Maximum Rate is 175% of higher index
[4] Auction Failed Rates are contingent on underlying rating of issuer. These percentages reflect rates at current rating

Insurance Exposure

Insurer	Outstanding	% Total
FSA	$187,575	9.55%
XLCA	$903,325	45.98%
AMBAC	$873,625	44.47%
MBIA		
FGIC		
CIFG		
	$1,964,525	100.00%

EXHIBIT 2

Bond Insurers Ratings Summary

	Rating Agency Outlook (As of 2/25/2008)		
	Moody's	**S&P**	**Fitch**
Ambac	Aaa	AAA	AA
	Review for Downgrade	Creditwatch: Negative Implications	Rating Watch Negative
	1/17/2008	2/25/2008	1/18/2008
Assured Guaranty	Aaa	AAA	AAA
	Stable Outlook	Stable Outlook	Stable Outlook
	12/14/2007	2/25/2008	12/12/2007
CIFG	Aaa	AAA	AAA
	Negative Outlook	Negative Outlook	Rating Watch Negative
	12/14/2007	2/25/2008	2/5/2008
FGIC	A3	A	AA
	Review for Downgrade	Creditwatch: Developing Implications	Rating Watch Negative
	2/14/2008	2/25/2008	1/30/2008
MBIA	Aaa	AAA	AAA
	Review for Downgrade	Negative Outlook	Review for Downgrade
	1/17/2008	2/25/2008	2/5/2008
Security Capital Assurance (XL)	A3	A-	A
	Negative Outlook	Creditwatch: Negative Implications	Rating Watch Negative
	2/7/2008	2/25/2008	1/24/2008
FSA	Aaa	AAA	AAA
	Stable	Stable	Stable
	12/14/2007	2/25/2008	12/17/2007

EXHIBIT 3

Houstion Combined Utility Average Tax-Exempt Auction Rate Vs SIFMA Index